Lazard
Select Australian Equity Fund

Nov 2022
Factsheet

High Conviction
Benchmark unconstrained, with high active share and best ideas

Disciplined 'Value' Investment Approach
Longer-term Independent thinking

Stability and Experience
Team together at Lazard for more than 20 years

Performance[2] (%)

	Lazard	Index	Excess Return
1 Month	4.8	6.6	-1.8
3 Months	6.9	6.0	0.9
1 Year	32.4	5.0	27.3
3 Years (pa)	9.2	5.9	3.2
5 Years (pa)	7.9	8.2	-0.3
10 Years (pa)	11.0	9.4	1.6
Since Inception (pa)	9.5	8.8	0.7

Investment Characteristics

	Lazard	Index
Price/Cash Flow	6.3	9.0
Price/Book Value	1.5	2.1
Dividend Yield (%)	4.6	4.4
Forward Price/Earnings	11.2	14.5
Active Share (%)	75.3	-
3 Year Turnover (%pa)	76.1	-

Fund Facts

Number of stocks	32
Total Fund Size	$69.7m
Inception Date	22 August 2002
Total Management Costs	W Class: 1.15% p.a.
Index	S&P/ASX 200
Minimum Investment	$20,000
Buy/Sell Spread	0.20%/0.20%
Distributions	Quarterly[1]
APIR Code	LAZ0013AU

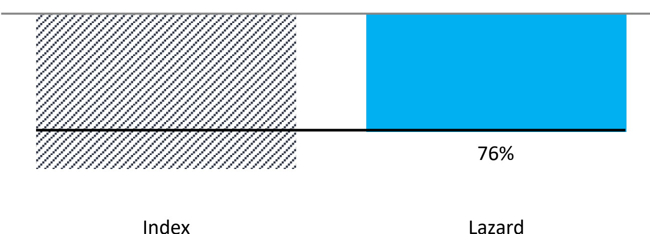
Allocations (%)

Sector	Lazard	Index	Overweight/ Underweight
Communication Services	1.6	3.8	-2.2
Consumer Discretionary	9.5	6.3	3.2
Consumer Staples	10.4	4.7	5.7
Energy	17.5	6.3	11.2
Financials	31.1	28.7	2.4
Health Care	1.7	10.0	-8.3
Industrials	7.1	5.8	1.3
Information Technology	1.0	2.7	-1.7
Materials	16.4	24.2	-7.8
Real Estate	3.1	6.1	-3.0
Utilities	0.0	1.5	-1.5
Cash	0.7	0.0	0.7

Top 5 Holdings (%)

	Lazard	Index
QBE Insurance	10.2	0.9
Woodside Energy	9.1	3.3
Rio Tinto	8.1	1.9
AMP	8.0	0.2
Santos	5.4	1.2

Down Market Capture Ratio



Down Market Capture Ratio is calculated since inception and based on performance gross of all fees. Down Market Capture is a statistical measure of an investment manager's overall performance in down markets, being calendar months where the Index experiences negative performance. A drawdown ratio (or percentage) of less than 100 (or 100%) reflects that the manager has outperformed the Index during such down markets.

1 Distributions are made quarterly if of an economic size.

Performance is presented net of W Class fees, please refer to www.lazardassetmanagement.com for performance of the I Class.

Investments can go up and down. Past performance is not necessarily indicative of future performance. Net returns are quoted after the deduction of Management Costs. Performance assumes reinvestment of all distributions.

LAZARD
ASSET MANAGEMENT

Commentary

Equities had a strong month in November 2022 following on from a strong performance in October, as Federal Reserve Chair Powell's comments on potentially slowing rate hikes "as soon as December" provided relief to markets. The S&P/ASX 200 outperformed the developed market indices, rising over +6% during November, as investors responded to a more dovish than expected RBA 25bps hike to 2.85% during the month. This was reflected in Australian bond markets, as the Australian 10-year yield moved down by 23bps to 3.53%. On a sector basis, Utilities was the strongest performer, while Materials, and Health Care also outperformed in Australia. The Communication Services, Financials and Energy sectors were the relative worst performers.

During the month ended November 2022, the Lazard Select Australian Equity Fund returned 4.8% (net of W Class fees), underperforming the S&P/ASX 200 Accumulation Index which returned 6.6%.

Contributors to Performance

- Rio Tinto's (RIO) share price rebounded strongly in November as the Chinese government's push for a reopening of the economy gathers pace. This expectation has helped boost sentiment in the market and boost commodity prices. Iron ore was up more than 20% and the aluminum price recovered more than 10% during the month. Consumer confidence in China, however, is still very low and property data continues to be very weak; these are the key fundamental demand drivers of commodities in China. Property accounts for 40% of steel demand in China and infrastructure stimulus can't make up the shortfall representing only 15% of demand. Fear of recession in the rest of the world will also continue to weigh on the broader demand for metals in the near-term. For our RIO valuation we are factoring some headwinds for near-term recession risk. In the medium to long -term, we have a conservative view on iron ore and capitalize earnings on our long-term price of US$60/t which is lower than the spot price of US$100/t. In contrast, we have a more bullish view on RIO's aluminum business. We see this business as structurally more profitable in the medium to long-term as demand accelerates, driven by the global energy transition, and combined with an underinvestment in supply. RIO is one of the lowest cost aluminum producers with the lowest CO2 intensity globally. Putting these views together, despite near-term earnings headwinds, we see RIO's current share price as relatively attractive.

- Computershare (CPU) outperformed the market in November following a trading update at the company's AGM, which pointed to margin income guidance likely being beaten by over 20 per cent in FY23, and by a similar amount the following year. The implied margin income yield therefore is at a 14 year high. As we like to focus on what a company can earn sustainably, we used the occasion to take profit in CPU, noting that updated expectations of global rate hikes through 2023 in the face of early signs of inflation deceleration and slowing GDP growth, increased the risks to margin income. The company otherwise remains a steady dividend payer with a strong balance sheet at a relatively fair valuation of 16.5x forward P/E.

Detractors from Performance

- Ridley (RIC) fell in November, underperforming the ASX200 which rose 6%. There was no company specific news during the month, and it appears RIC was impacted by the large share price decline of agricultural peer Elders, which gave a more cautious outlook statement than expected. We see minimal implications for RIC from the Elders update, noting RIC's earnings growth plans are largely dependent on internal initiatives. At subsequent investor briefings, the company has reiterated that there has been 'no change' to the full year outlook given in August 2022 and a small on market share buyback has been activated. We continue to hold RIC.

- Our investment thesis in Mayne pharma (MYX) has always been built on a sum-of-the-parts methodology. We have determined values for the different businesses to arrive at a whole of business valuation, or to provide insights into what the current share price implies for the components. In August 2022, MYX announced the sale of its MCS business for A$722m (16x LTM EBITDA). This confirmed the very high price we thought was possible in our SOTP valuation. Post the sale, MYX had net cash in the balance sheet of 18cps after repayment of all debt, leases and the receivables facility. In addition, shareholders had remaining legacy businesses in Dermatology, the Australian CDMO (MPI International) and a small declining Generics division. On top of this net cash and the legacy businesses, sits the enormous Nextstellis option. This is a unique oral contraceptive drug (approved by the FDA late last year), the first made with natural estrogen and with less side-effects than traditional oral contraceptives. However, Nextstellis comes with a large sales and marketing expense, and these have forced MYX into P&L losses until revenue grows to cover these costs. The share price weakness in November was more directly attributable to the AGM update which reported very disappointing revenue in the Dermatology business. This has been one of the good news stories for MYX but the AGM update suggests channel-stuffing in 2H'FY22 and gives investors less confidence in underlying revenue growth and profitability of that business. In recent days, MYX has also announced a licensing agreement which adds a handful of patented women's health products. We believe these should enable MYX to spread the sales and marketing expense of Nextstellis across a larger portfolio of products, hopefully delivering a quicker breakeven in women's health including Nextstellis. The share price is currently cum a fully franked dividend and a capital return totaling 6.5cps – equivalent to 28% of the 30 Nov 22 closing share price of 23cps. Despite these setbacks, we believe MYX still represents compelling value, and we remain invested.

Outlook

In retrospect we can now identify 9 November 2020 as an important turning point of internal stock market dynamics in Australia, even if speculative activity only reached its peak in the first quarter of 2021. Value style started to outperform from November 2020, although to the end 2021, better returns were driven entirely by superior EPS growth, partly offset by continuing increases in the dispersion of valuations due to ever increasing multiples for the high multiple stocks of the ASX. This widening dispersion finally started to reverse over January and February of 2022, resulting in dramatic relative gains for our portfolios. As of end of March 2022, about 40% to 50% of the gap that had opened up had mean-reverted, when measured against the benchmark of the last 25 low inflation years and dispersion measures tracked mostly sideways over the June quarter. Even after the 1H22 unwind of the 2020/21 excesses, absolute forward earnings multiples for the high quintile multiple stocks remain near the levels of March 2000, and the majority of the relative mean-reversion and thus of the associated out-performance is yet to unfold. History suggests that a distortion of this magnitude, which has built up over several years of boom, will similarly correct over a multi-year period, but so far, the mean reversion has been more rapid than in the "tech wreck" years of 2000-2003 or post the China boom of 2007. This may be due to the greater extremes reached and/or the current inflation risks that were not present in these prior post-bubble normalisations. Historical experiences suggest, however, that the rapid unwind of the bubble over the last seven months is unlikely to continue in such a straight-line fashion, as even during the March 2000 to March 2003 "tech wreck", there were several explosively rapid ~30% rallies in the NASDAQ, even as the overall index declined 80%. We should experience similar market volatility over the current normalisation period as well.

A significant contributor to outperformance over 1H22 were our Energy positions. Even following the gains in 2022 to date, the sector remains very attractively priced as the sector price index continues to be below end 2019 levels, for example, despite dramatic increases in coal, gas and oil prices since that time and we have only lowered the Fund's exposure modestly through the period. The increased likelihood of a US recession presents risks to energy commodity prices, but there is considerable structural support from accumulated under-investment.
In prior quarterly commentary we have focused on the inflation risks arising from the MMT-driven increases in broad money across the western world and the US in particular, where a wage-price feedback dynamic has developed. Exogenous shocks on Western inflation have come from the Russian-Ukraine conflict placing upward pressure on food and energy prices, off-set by China's economic problems arising from its adherence to a COVID-19 elimination strategy in the face of increasingly infectious omicron sub-variants.

We outline our market expectations in low or high inflation scenarios below.

1. If inflation subsides, rates remain in the low range that has prevailed over the last 30 years and market multiples remain supported by the "Fed put", we expect outcomes similar to those following 2001 – an extended period of normalisation of relative multiples driving value out-performance, in the context of overall negative US and subdued Australian equity returns.

2. If inflation rates remain significantly higher than central bank targets, a global or at least developed world recession, we believe, is almost certain within the next 18 months. Returns across all asset classes – bonds, property, equities – would likely be negative, some significantly so, but the relative gains by value equities would probably be even greater than those that seem likely from multiple normalisation in any case. The combination of extreme distortions as the starting point and a rise in inflation could potentially result in the most dramatic relative gains by value stocks since the early 1970s..

For very different reasons, namely a property downturn, the risk of a Chinese recession is thus also greater than usual. Such a recession could alleviate food, commodity and energy inflation pressures globally and thus may even be of some net benefit for western commodity-importing manufacturing nations, although we consider it would be a significant negative for Australia.

Domestically, the rise in interest rates once more raises the risks associated with extended home prices and the high level of household debt, and we are watching house price developments in New Zealand closely, as rates rose earlier in that market. As of the end of June 2022, CoreLogic report that Auckland prices had declined by 10.5% from the 2021 peak, which by itself this decline is not concerning, and national prices have declined by less, but the rate of decline is rapid for residential property and the rate of decline has accelerated. We see an approximately 15% national decline as approaching a "danger zone" beyond which internal market dynamics and self-fulfilling sentiment changes could potentially lead to a recession and yet further falls beyond the ability of monetary policy to prevent.

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